



Goodwill Impairment Valuation Insights

A discussion of the market participant acquisition premium

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In goodwill impairment tests, market participant acquisition premiums (MPAPs)¹, also referred to as control premiums, are often one of the most critical inputs to the valuation analysis. The size of the MPAP can determine whether a reporting unit passes the quantitative test or the amount of impairment if a reporting unit fails. In addition, the MPAP assumption typically involves a significant degree of judgment, making it one of the most scrutinized assumptions in a goodwill impairment analysis.

In periods of significant stock declines, MPAPs can be a topic of increased debate. In particular, when public markets exhibit widespread downward trends, it can become difficult to reconcile to the observed market capitalization under a “normal” MPAP. Therefore, consensus regarding the range of acceptable MPAPs becomes critical under these circumstances.

MPAPs may be expressed as a percentage of a company’s business enterprise value (BEV)² or as a percentage of the company’s market capitalization (equity). For the purpose of this discussion, we will refer to a MPAP expressed as a percentage of equity, which is common in performing the market capitalization reconciliation exercise.³



Applying MPAPs in the market capitalization reconciliation

When performing a market capitalization reconciliation exercise, the MPAP can be a critical assumption requiring significant support. In general, as the MPAP increases, more robust support will be required. This was confirmed by Robert G. Fox III of the SEC in his December 8, 2008 speech.



I would also note that the amount of supporting evidence supporting your judgment would likely be expected to increase as any control premium increases.



KPMG’s experience with the application of MPAPs in goodwill impairment analyses has been consistent with the SEC’s statement above. For example, in cases where an equity MPAP is below 20 percent, the analysis may be limited to documenting observed industry premiums and qualitatively describing the relevance of these transactions to the subject company.

¹ MPAP is defined as the difference between the pro rata fair value of the subject controlling interest and its foundation. Essentially, the MPAP quantifies the additional value created by controlling the stewardship of the enterprise.

² Business Enterprise Value = Equity Market Capitalization + Fair Value of Debt – Cash

³ Note that expressing the MPAP as a percentage of equity can distort the comparability of MPAPs among target companies with different capital structures. For purposes of simplicity, we have assumed the target companies have consistent capital structures.



As the equity MPAP increases above 20 percent,⁴ a closer look at the transaction support may be warranted. In these cases, a detailed analysis of the qualitative factors referenced in the Appraisal Foundation's *Valuations in Financial Reporting Valuation Advisory 3: The Measurement and Application of Market Participant Acquisition Premiums* can be helpful. One should also consider the factors described in 4.83 of the AICPA Accounting and Valuation Guide—Testing Goodwill for Impairment that could lead to potential differences between the estimated fair value and the observed market capitalization of the business. In situations where the MPAP significantly influences an impairment decision or falls at the upper end of the observed range for the industry, additional quantitative analyses may be needed as well.

As equity MPAPs approach 40 percent or greater, more effort will likely be spent supporting this assumption. Oftentimes, this is done by quantifying the present value of market participant synergies that can be realized from the acquisition of the subject company. In these situations, the anticipated synergies need to be well documented. In addition to quantifying synergies, the processes described in the preceding paragraphs will be critical to supporting the MPAP.

In our experience, equity MPAPs above 50 percent are rarely utilized in goodwill impairment analyses if the subject company has a typical capital structure. However, in periods of significant market contraction, such as the 2008-2009 financial crisis, equity MPAPs in this range are relatively more common. Shown below is a comparison of equity MPAPs in the recent past compared to those observed in the 2008-2009 financial crisis.⁵

Observed Equity MPAPs			
Percentile	2018-19	2008-09	Difference
25.0%	15.8%	25.1%	9.3%
50.0%	27.8%	38.9%	11.2%
75.0%	45.7%	63.0%	17.4%
90.0%	71.8%	96.4%	24.7%

⁴ It is important to note the MPAP percentages referenced in this document are based on general observations and should not be viewed as precise breakpoints. Actual MPAP thresholds can vary by industry and specific circumstance.

⁵ MPAP data based on information sourced from S&P Capital IQ.

⁶ A P/B multiple is the ratio of a company's publicly traded market capitalization to its book equity value.

Relationship between P/B multiples and MPAPs

Since a goodwill impairment test compares the fair value of a company's reporting unit(s) to its carrying value, the price to book (P/B) multiple⁶ can be a good indicator of a company's risk of impairment. In particular, as the P/B ratio drops below 1.0x, there is increased risk of impairment as the fair value of equity no longer exceeds the corresponding carrying amount. As mentioned previously, a publicly-traded company's observed stock price can impact the goodwill impairment test. This is especially true for publicly-traded companies with only one reporting unit or when a market capitalization reconciliation exercise is performed.

To illustrate this concept, let's assume a publicly-traded company has one reporting unit, a market capitalization of \$500 million, and a book equity value of \$500 million. Given this fact pattern, the company would be trading at a price/book (P/B) multiple of 1.0x and the reporting unit's fair value, represented by the company's market capitalization, would equal its carrying value before the application of any MPAP.

In this example, let's further assume the company's market capitalization subsequently declines to \$300 million. As a result, its observed P/B multiple would fall to 0.6x. In order for the reporting unit's fair value of equity to exceed its carrying value of \$500 million, an equity MPAP of 66.7 percent would need to be applied to the company's market capitalization. These calculations are demonstrated in the following table.

Calculation of required equity MPAPs			
		Case 1	Case 2
Fair value of equity	[A]	\$500	\$300
Book value of equity	[B]	\$500	\$500
P/B multiple	[C]= [A]/[B]	1.00x	0.60x
MPAP required to pass	[D]= 1/[C] -1	0.0%	66.7%

Per our prior discussions, supporting a MPAP at this level will likely require significant documentation and may fall outside the supportable range in some instances.

The table below takes this concept a step further by calculating the equity MPAP necessary to reconcile the market capitalization and book equity value at various P/B multiples.

Equity MPAP Needed to Equal Book Value of Equity			
P/B	MPAP	P/B	MPAP
1.00x	0.0%	0.50x	100.0%
0.90x	11.1%	0.40x	150.0%
0.80x	25.0%	0.30x	233.3%
0.70x	42.9%	0.20x	400.0%
0.60x	66.7%	0.10x	900.0%

Consistent with prior commentary, the shading on the table illustrates the increased level of effort and risk incurred as the P/B multiple falls and the required MPAP increases.

Implications for companies with multiple reporting units

The market capitalization reconciliation exercise can be more complex for companies with multiple reporting units. When performing an impairment test, all reporting units may need to be valued independently on a controlling basis. The market capitalization reconciliation is completed by comparing the market capitalization of the company plus the MPAP to the sum of the reporting unit values. If the reconciliation is inconsistent with expectations, there are a number of reporting unit assumptions that may need to be revisited in order to derive a supportable fair value conclusion.

Summary

When performing a goodwill impairment test, one must ensure that the MPAP assumption is well documented. The documentation requirements will increase with the size and importance of this assumption relative to the impairment conclusion.

Additional resources

KPMG's guidance, updates and news covering financial reporting impacts of the COVID-19 outbreak can be found here: <https://frv.kpmg.us/all-topics/coronavirus.html>.

For a more detailed look at financial reporting impairment considerations refer to **Hot Topic – Increased risk of impairment of goodwill and long-lived assets** available here: <https://frv.kpmg.us/reference-library/2020/coronavirus-related-impairment-nonfinancial-assets.html>.

Have questions?

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